By **Michelle Ward** & **Mark Merric**

Creditor Protection for IRAs

A shift in favor of debtors has started to occur

For many individuals, qualified retirement assets, including individual retirement accounts, represent a substantial portion of their wealth. It's estimated that approximately $17 trillion is currently held in retirement accounts in the United States.[1] The benefits afforded by allowing assets to grow in a tax-deferred environment can give rise to tremendous wealth accumulation during the owner's life and, if structured properly, to the owner's family. These facts, combined with the litigious nature of our society, highlight the importance of protecting retirement assets from creditors. Fortunately, there's a level of creditor protection available to IRAs.

Bankruptcy

On April 20, 2005, then-President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the Act).[2] The main purpose of this law was to stop perceived abuses in the bankruptcy system. The Act, however, also expanded protection to more types of retirement accounts, including IRAs and Roth IRAs. Previously, only stock bonus, pension, profit-sharing, annuity or similar plans or contracts were protected from creditors.

Prior to the Act, retirement accounts were governed by either: (1) state exemption law, if the state had opted out of the old Bankruptcy Code exemptions, or (2) a limited set of Bankruptcy Code exemptions. In passing the Act, Congress created a new class of exemptions that apply regardless of whether the state of domicile has opted out of the federal scheme for other property. Of this class, 11 U.S.C. Section 522(b)(3)(C) applies in opt-out states and Section 522(d)(12) applies in the federal exemption scheme. The two provisions are now identical and provide an exemption for retirement funds to the extent that those funds are in a fund or account that's exempt from taxation under Internal Revenue Code Sections 401,[3] 403,[4] 408,[5] 408A,[6] 414,[7] 457,[8] or 501(a).[9] For a retirement account to fall under the exemption of Section 522(b)(3)(C), two elements must be present:

1. the amount the debtor seeks to exempt must be in retirement funds; and

2. those retirement funds must be in an account that's exempt from taxation under IRC Sections 401, 403, 408, 408(A), 414, 457 or 501(a).

IRAs and Roth IRAs are now specifically exempt from creditors under the law, but only up to $1 million (as adjusted for inflation). This $1 million limit for IRAs and Roth IRAs doesn't include rollover amounts,[10] nor is it applicable to simplified employee pensions under IRC Section 408(k) or simple retirement accounts under IRC Section 408(p). For example, if a taxpayer rolled over $3 million from a qualified plan into an IRA, the entire $3 million, plus earnings, is protected. The $1 million limit can also be increased if the "interests of justice so require."[11]

Planning note: Because a rollover IRA, plus the earnings and appreciation on the rollover amount, is fully protected, we recommend that clients keep rollover IRAs segregated from contributory IRAs. Further, clients should keep documentation of the rollover in a

Michelle Ward is a partner at Keebler & Associates LLP in Green Bay, Wis. **Mark Merric** is director of International Tax Services for GHP Horwath P.C. and the manager of the law firm of Mark Merric, LLC, both in Denver

permanent file, and the IRA should include the word "rollover" in its name. By doing so, if the bankruptcy trustee asks a client to prove that such amount was from a rollover, he would be able to easily do so. Conversely, without the documentation, a part of an IRA account may not be protected within the $1 million threshold.

In general, when a client files for bankruptcy, IRA and Roth IRA owners can now feel confident that their accounts will be protected without having to look to applicable state law in hopes of obtaining favorable treatment. While this is the case for IRAs and Roth IRAs that were funded by the debtor, there's conflicting authority on whether an inherited IRA is protected in bankruptcy. We'll address this issue after we discuss non-bankruptcy issues.

> The IRC and underlying regulations ensure that the original retirement funds are protected and remain unchanged in character.

Non-Bankruptcy

Because the Employee Retirement Income Security Act's (ERISA) anti-alienation rules don't apply to IRAs,[12] whether an IRA is protected from the reach of creditors in a non-bankruptcy case depends on state law. Most states provide some level of protection to IRAs, with the majority favoring complete exemption. Some states limit the exemption to the amount necessary to provide for the reasonable support of the debtor.[13]

Note that, despite creditor protection under state law, the Internal Revenue Service can issue a levy on an IRA for a federal tax lien.[14] The Internal Revenue Manual, however, states that if there's property other than the IRA that can be used to collect the liability or if a payment agreement can be reached, the agent should consider these alternatives before issuing a levy on the IRA. The Manual goes on to state that because "these retirement vehicles provide for the taxpayer's future welfare," if "the taxpayer has not engaged in flagrant conduct, [the agent is not to] levy on retirement accounts."[15] If the taxpayer is dependent on the funds in the IRA (or will be in the near future), the agent is also instructed not to levy the account.[16]

Inherited IRAs: Bankruptcy

Although the Act extended protection to IRAs, the courts have been divided as to whether this includes inherited IRAs.

Previously, most courts ruled in favor of the creditors and denied creditor protection to inherited IRAs.[17] When holding that an inherited IRA isn't exempted from the bankruptcy estate, the bankruptcy courts often found that an inherited IRA was significantly different from an IRA under the IRC.[18]

The bankruptcy courts have listed the following differences between an IRA and an inherited IRA:

1. A beneficiary of an inherited IRA can't make contributions into the account;

2. A beneficiary of an inherited IRA can't roll the IRA into another retirement plan; and

3. An IRA must be distributed within five years, and those distributions are fully taxable.

In most of the unfavorable cases, the bankruptcy courts didn't rely on a plain reading of the statute. Rather, they created a judicial exception that distinguished inherited IRAs from IRAs and allowed a creditor to reach the inherited IRA.

In the case of *In re Kirchen,*[19] for example, an inherited IRA wasn't allowed a bankruptcy exemption because it "had transformed into a source of immediately payable income to the Debtor, regardless of his age or retirement status" and, therefore, was not received "by reason of age, illness, disability, death or length of service," as required under Wisconsin law.[20]

More recently, however, there appears to be a shift in favor of debtors.

In *In re Thiem,*[21] the court disagreed with previous courts that denied the exemption, stating that even though inherited IRAs are treated differently under the

IRC, they're still protected from taxation until amounts are required to be distributed under the IRC. The court pointed out that the IRC and underlying regulations ensure that the original retirement funds are protected and remain unchanged in character, for example, by prohibiting contributions and rollovers to the new account. It further stated that both ordinary and inherited IRAs are exempt from taxation, and that's all that Section 522 requires.

The *Thiem* court also indicated that none of the cases denying the exemption analyzed Sections 522(b)(3)(C) or 522(b)(4)(C). The plain language of Section 522(b)(4)(C) provides that transfers that create an inherited IRA don't cause a loss of exemption eligibility. In addition, the court didn't agree with the cases that required a retirement purpose to obtain exemption, by stating that neither Section 522(b)(3)(C) nor Section 522(d)(12) require the retirement funds to be those originally created by the debtor-beneficiary. Instead, the court held that an inherited IRA that complies with the IRC is, in name and substance, an account that meets the requirements of the federal retirement exemption statutes at issue.

In re Nessa[22] involved a situation in which the debtor made a trustee-to-trustee transfer of her deceased father's IRA to her own account, without rolling over the account to her own IRA, taking any distributions from her father's IRA or contributing any of her own funds to the inherited account. The court found that for an IRA to be exempt under Section 522(d)(12), it must meet only two requirements: (1) the amount the debtor seeks to exempt must be retirement funds; and (2) the retirement funds must be in an account that's exempt from taxation under one of the provisions of the IRC specified in Section 522(d)(12).

The *Nessa* court first found that the funds at issue were retirement funds, even though they were the retirement funds of the debtor's father, rejecting the argument that the retirement funds must be created from the debtor's own assets. The court then determined that an inherited IRA is tax-exempt under IRC Section 408(e), rejecting the argument that an inherited IRA is different from other tax-exempt IRAs simply because it's subject to certain rules in other parts of the IRC, especially in terms of distributions. The court pointed out that IRC Section 408(e) provides that "[a]ny individual retirement account is exempt from taxation."

The bankruptcy court in *In re Kuchta*[23] also concluded that an inherited IRA was exempt under Section 522(b)(3)(C). As in *Nessa*, the debtor's inherited IRA account was established through a direct trustee-to-trustee transfer of the inherited assets.

The court in *In re Tabor*,[24] citing *Nessa*, stated that Section 522(d)(12) requires that the account be comprised of retirement funds, but it doesn't specify that they must be the debtor's retirement funds. The *Tabor* court also stated that the distinctions made by the trustee between the tax treatment of inherited IRAs and ordinary IRAs, while accurate, weren't significant to the court's determination and that both types of accounts are exempt from taxation, which is all that's required by Section 522.[25]

In those jurisdictions that have unfavorable or conflicting precedent, it's advisable to consider an IRA payable to a trust for the benefit of the individual beneficiary to obtain stronger asset protection.

In *In re Chilton*,[26] the district court reversed the bankruptcy court's holding that the debtor's inherited IRA wasn't exempt. The bankruptcy court had concluded that an inherited IRA isn't equivalent to an ordinary IRA for purposes of determining whether the account contained retirement funds that may be exempted under Section 522(d)(2). Again, the district court found that Section 522(d)(12) doesn't require that the retirement funds be the debtor's and that the transfer of the deceased IRA to an inherited IRA doesn't remove the transfer from eligibility for exemption under Section 522(d)(12).

Even assuming that the inherited IRA did contain

retirement funds, the bankruptcy court in *Chilton* also found that the inherited IRA wasn't a traditional IRA exempt from taxation under IRC Section 408(e)(1). The district court, however, rejected this argument by stating that the "plain meaning of [IRC Sec. 408(e)] does not limit the section to traditional IRAs, but could include inherited IRAs."

Inherited IRAs: Non-Bankruptcy

If the applicable state exemption statute specifically mentions inherited IRAs, these IRAs would be exempt. Unfortunately, the majority of states don't provide such specific language. Rather, these statutes use the term "IRA" or a "similar plan," referring to the IRA as a retirement plan. One notable exception is Florida. In 2011, Florida, which previously had precedent unfavorable to debtors,[27] enacted a statute specifically expanding creditor protection to inherited IRAs.[28]

SPOT LIGHT

Leaving an Impression

"L'Avant-port de Dieppe, Après-midi, Temps Lumineux" (21.4 in. by 25.8 in.) by Camille Pissarro sold for $1,538,500 at Sotheby's Impressionist & Modern Art Evening Sale in New York on May 2, 2012. Known as the "dean of impressionist painters," Pissarro was the fulcrum of a group of 15 of the era's leading artists and was viewed as a mentor by such luminaries as Gauguin, Cézanne and Renoir.

For states that don't have specific language exempting inherited IRAs, the question becomes whether the courts would follow the plain meaning of a statute to include inherited IRAs. The inherited IRA is the result of the death of the original owner of the IRA and, if challenged, an argument would have to be made that the inherited IRA does, in fact, meet the requirements of the language of a particular statute.

IRA in Payout Status

There are further complications when an inherited IRA is in payout status, and no specific state statute protects distributions received by the beneficiary of an inherited IRA.

Since the *Restatement (Second) of Trusts*, distributions from a spendthrift trust haven't been protected from attachment by a creditor.[29] The same conclusion was reached in an ERISA-protected retirement plan context. In *Guidry v. Sheet Metal Workers Int'l Ass'n.*, the U.S. Court of Appeals for the 10th Circuit allowed the creditor to garnish distributions received from a retirement plan, even if the distributed funds were held in a segregated account.[30] This analogy should apply to inherited IRAs if the IRA state exemption statute was unclear on protecting distributions.

Planning Opportunities

So, what should a planner recommend to obtain better asset protection while still receiving the benefits of the tax-free compounding over the beneficiary's life in an IRA? In those jurisdictions that still have unfavorable or conflicting precedent, it's advisable to consider an IRA payable to a trust for the benefit of the individual beneficiary to obtain stronger asset protection. In addition, an IRA payable to a trust rather than an individual protects against the individual beneficiary moving to a jurisdiction with unfavorable precedent.

The standalone IRA trust combines the asset protection benefits of trust law with the tax-free compounding of the inherited IRA. It's specifically designed to spread out the required minimum distributions over the life of the beneficiary and still retain the benefits of spendthrift protection. A standalone IRA trust doesn't depend on a state exemption statute; its protection is based on the asset protection benefits of trust law.

There are numerous traps that often are unavoidable

or missed when using a trust that was drafted for other purposes, such as a credit shelter trust, even when attempts are made to create a firewall between a particular beneficiary's sub-trust and the rest of the credit shelter trust's terms.[31] To ensure that the client's estate-planning goals are met without the loss of tax deferral, practitioners may be well-advised to use a trust specifically designed for stretching out retirement account distributions over the trust beneficiary's lifetime. Such a trust must comply with the required minimum distribution rules that apply to trusts.[32]

Endnotes

1. Investment Company Institute, The U.S. Retirement Market, Fourth Quarter 2010, April 2011.
2. Public Law 109-8.
3. Qualified pension, profit-sharing and stock bonus plans.
4. Employee annuities.
5. Individual retirement accounts.
6. Roth IRAs.
7. Multi-employer annuities.
8. Deferred compensation plans of state and local governments and tax-exempt organizations.
9. Tax-exempt organizations.
10. Rollover contributions under Internal Revenue Code Sections 402(c), 402(e)(6), 403(a)(4), 403(a)(5) and 403(b)(8).
11. 11 U.S.C. Section 522(n).
12. Traditional and Roth IRAs aren't mentioned in the Employee Retirement Income Security Act (ERISA). Simplified employee pension IRAs and single owner retirement plans are specifically carved out of ERISA protection. ERISA 206(d).
13. *See, e.g.*, Maine Rev. Stat. Ann. Title 14 Section 4422(13)(E).
14. *See* IRC Sections 6331 and 6334.
15. *See* Internal Revenue Manual Section 5.11.6.2.
16. *See* I.R.M. Section 5.11.6.2(7).
17. *See* Robert S. Keebler and Mark Merric, "Are Inherited IRAs Protected Under State Exemption Statutes?" *Steve Leimberg's Employee Benefits and Retirement Planning Newsletter*, #427, Sept. 7, 2007 (noting that the first six cases held that inherited IRAs weren't protected).
18. *In re Taylor,* 2006 Bankr. LEXIS 755, 2006 WL 1275400 (Bankr. C.D. Ill. 2006).
19. *In re Kirchen*, 344 BR. 908 (Bankr. E.D. Wis. 2006).
20. *See also In re Jarboe*, 365 B.R. 717 (Bankr. S.D. Tex. 2007) (inherited IRA "is not a retirement plan" because the beneficiary can take distributions at will without penalty; therefore, the IRA isn't exemptible under Texas law); *In re Sims,* 241 B.R. 467, 470 (Bankr. N.D. Okla. 1999) (inherited IRA isn't exemptible from bankruptcy estate under an Oklahoma exemption statute because the IRC "places an entirely different set of rules upon the use, distribution and taxation" of its funds than originating account); *In re Navarre,* 332 B.R. 24 (Bankr. M.D. Ala. 2004) (an inherited IRA is "sufficiently different" from a regular IRA so as to preclude exemption from a bankruptcy estate under Alabama law).
21. *In re Thiem*, 107 A.F.T.R.2d 2011-529 (Bankr. Ariz. Jan. 19, 2011).
22. *In re Nessa,* 2010 WL 128313 (Bankr. D. Minn. 2010), *aff'd* 426 B.R. 312 (B.A.P. 8th Cir. 2010).
23. *In re Kuchta,* 434 B.R. 837, 843 (Bankr. N.D. Ohio 2010).
24. *In re Tabor*, 433 B.R. 469,105 A.F.T.R.2d 2010-2964 (Bankr. M.D. Pa. 2010).
25. *See also In re Weilhammer*, 2010 WL 3431465 (Bankr. S.D. Cal. Aug. 30, 2010).
26. *In re Chilton*, 105 A.F.T.R.2d 2010-1271 (Bankr. E.D. Tex. 2010).
27. *See In re Ard*, 435 B.R. 719 (Bankr. M.D. Fla. 2010) and *Robertson v. Deeb*, 16 So.3d 936 (Fla. Dist. Ct. 2009).
28. Section 222.21(2)(c) of the Florida Statutes.
29. *Restatement (Second) of Trusts*, Section 152 comment; *Lundgren v. Hoglund,* 711 P.2d. 809 (Mont. 1985).
30. *Guidry v. Sheet Metal Workers Int'l Ass'n.,* 39 F.3d 1078 (10th Cir. 1994).
31. *See Commerce Bank N.A. v. Bolander,* 154 P.3d 1184 (Ct. App. Kan. 2007), for a case suggesting that such a trust should be irrevocable ab initio.
32. *See* Treasury Regulations Section 1.401(a)(9)-4, Q&A 5.

SPOT LIGHT

Standing Alone

"Champ à Giverny" (26 in. by 36.4 in.) by Claude Monet sold at Sotheby's recent Impressionist & Modern Art Evening Sale in New York on May 2, 2012 for $2,658,500. Monet founded the impressionist movement and was its most prolific artist. The movement's name itself is derived from the title of Monet's painting, "Impression, Soleil Levant" (Impression, Sunrise).